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Third World Debt

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Background: The ability of many capital-importing Third World countries to service their external debt deteriorated sharply between 1980 and 1982. The US responded by developing a flexible, case-by-case approach stressing economic adjustment by debtors and support for adjustment by the industrialized countries, the International Monetary Fund (IMF), and the commercial banks. This approach has evolved over time, stimulated particularly by Treasury Secretary Baker's 1985 proposal for a "Program for Sustained Growth."

Magnitude: By the end of 1984, the gross external debt of the Third World countries exceeded $800 billion, almost double the 1979 total. The countries of Latin America and the Caribbean account for more than 40% of the total. Brazil and Mexico each owe about $100 billion; Argentina, close to $50 billion. Major Third World debtors outside the Western Hemisphere include South Korea ($48 billion), Indonesia ($34 billion), and the Philippines ($31 billion). The countries of sub-Saharan Africa account for about 10% of the total. Despite improvement in the quality and quantity of debt statistics, there is no single consistent set of data broken down by country and maturity; available data should be used with caution. In addition, reliable and consistent data on the internal debt of Third World countries do not exist. For 1984, total debt service was some $126 billion, with the average debt service ratio (debt service paid as a percentage of the value of exports of goods and services) between 20% and 26% annually during the early 1980s. The ratio for Latin America recently has been higher than the Third World average.

Origins of the crisis: The convergence of three major factors precipitated the debt crisis. Of greatest importance were the inappropriate domestic policies of many high debt countries. These policies included overvalued exchange rates; deficit spending, particularly to create many inefficient public sector enterprises; and restrictions and disincentives to trade and investment. External shocks, such as the 1979 oil price jump, a sharp run-up in real interest rates, and spreading recession in the developed countries, were a factor. Also many borrowers relied increasingly on short-term, variable-rate loans that made them especially vulnerable.

Initial response: Working with other international creditors, the US moved quickly in implementing rescue packages to deal with the immediate liquidity problems of the major debtors. These packages were made available on a case-by-case basis. Concurrently, we sought to develop a medium-term approach, which came to be known as the five-part strategy. It called for economic adjustment by debtors, growth with open markets in the industrialized countries, a strengthened IMF role, the continued prudent involvement of commercial banks with debtor countries, and short-term bridge financing by creditor governments in carefully selected cases. The strategy now

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includes calls for closer cooperation between the IMF and World Bank, multiyear debt rescheduling agreements by commercial banks, and greater reliance on foreign direct investment as a partial alternative to continued heavy borrowings.

Results: The US approach has succeeded in averting threats to the integrity of the world financial system. The strategy has led to a stronger IMF, better able to encourage broad, innovative international support for debtors. Many debtors were able to improve significantly their external accounts and halt and then reverse the economic decline of the early 1980s. By mid-1985, however, the view emerged that we needed to reinforce our approach. OECD growth was lower than projected, and protectionist pressures were intensifying. There was little or no growth in net commercial lending. In addition, it was increasingly recognized that debtors needed to do more to remove impediments to sustainable growth.

US Program for Sustained Growth: In an address to the joint Annual Meetings of the IMF and World Bank in October 1985, Treasury Secretary Baker proposed to build on our current approach. The initiative he announced sought to promote sustainable and balanced growth in the debtor countries and to restore their creditworthiness. The Program for Sustained Growth contains three mutually reinforcing elements, the key being the pursuit of comprehensive, growth-oriented economic policies in the debtor countries. Such policies would include deploying economic resources more efficiently, encouraging greater domestic savings and investment, attracting foreign equity capital, and returning public enterprises to private sector control.

The second element of the proposal, linked to policy reform, called for $20 billion in net new lending from the commercial banks over a 3-year period. The third element concerns the international financial institutions. The IMF would continue to play a central role and increase the structural reform content of its programs. The World Bank would expand its role and seek to streamline its disbursement procedures. Specifically, it would place more emphasis on non-project lending that encourages policy reforms and subsequent changes in investment patterns in the borrowing countries. Secretary Baker also called on the Inter-American Development Bank to play a more effective role in encouraging policy reform in Latin America and the Caribbean.

Reaction to the initiative: Reaction has been positive and encouraging. A consensus is emerging that a net increase in lending to middle-income debtors is needed and that it be tied to the adoption by debtors of sound macroeconomic and structural adjustment policies. All elements of the international financial community have voiced their support. Commercial banks are considering mechanisms for implementing pledges of support. International financial institutions are seeking to streamline disbursement procedures and expand the structural content of adjustment programs. And various debtor countries have taken steps to implement the policies Secretary Baker recommended. Ultimately, implementation of the debt proposal will be governed by the pace and type of negotiations that individual debtor nations have with the IMF and with the World Bank.

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